

Guidance About Insider Compensation

Compensation for any national bank can include salaries, bonuses, fees, benefits, or other goods and services. For a proposed bank charter, the organizing group should include in its OCC charter and FDIC deposit insurance applications a description of all forms of insider compensation, including stock-based compensation plans. The OCC reviews the organizers' approved compensation plans to determine if they are reasonable. The OCC's conclusions about the acceptability of a proposed bank's insider compensation package have a bearing on the overall assessment of the proposed bank charter application.

Organizers should establish compensation plans that are in the best interest of the bank and commensurate with the services provided. A new bank may include a stock benefit or compensation plan (stock benefit plan), including stock options, stock warrants, and similar stock-based compensation, as part of its overall compensation for organizers, directors, and officers provided that it structures the plans appropriately.

Regulatory Review of Compensation Plans

The OCC evaluates each proposed bank's total compensation package, including its stock benefit plan, to determine if it is reasonable considering each person's contribution of time, expertise, and financial commitment. The OCC assesses the amount and basis of any cash or stock payments an organizer may receive as a return for funds placed at risk or for services rendered. In addition, the OCC considers the number and percentage of additional stock warrants or options that are proposed relative to the number of shares the bank will issue at the time it opens.

The OCC also reviews, for consistency with this insider compensation policy, the compensation package for each newly organized bank holding company (BHC). A newly organized BHC is defined as one that has been operational for less than three years. If not disclosed in the charter application, the OCC considers bank director and senior executive officer participation in a newly organized BHC's stock benefit plan a "significant change" subject to prior OCC review and written non-objection determination.

The organizers should provide documentation to support the reasonableness of its compensation package, including the methodology used to value any stock options (such as, stock option pricing model or discounted cash flow analyses **and** relevant comparable data). The OCC has no preference about which method the organizing group uses for its valuation of stock options. The OCC also may consider changes to the new bank's overall compensation package after the application is filed a "significant change," which will require the OCC's prior non-objection before the bank can be allowed to open.

An established company¹ may have existing compensation plans in which the national bank's management and board may participate. The OCC will review such plans closely. Even if the existing plan would be inconsistent with the general criteria for new bank stock benefit plans, the OCC may allow bank management and board participation in limited circumstances. The OCC will consider whether such compensation, in combination with other forms of compensation, is reasonable.

The FDIC reviews compensation plans as part of its assessment of each deposit insurance application. The OCC and the FDIC apply similar standards to their separate evaluations of compensation plans. If the organizers would like the OCC to review proposals that may not conform to the guidelines in this policy, they should provide supporting information and justification to support a deviation from established policies.

In some circumstances, the exercise of rights granted by a stock benefit plan trigger filing to the OCC under the Change in Bank Control Act (CBCA) (12 USC 1817(j)) or the OCC's implementing regulation, 12 CFR 5.50. The OCC's review of stock benefit plans in connection with a charter application does not satisfy the prior notice requirements under the CBCA if the exercise of rights would trigger the prior notice requirements.

Unacceptable Forms of Compensation

The OCC considers as unacceptable any new bank compensation proposal that allow insiders to:

- Purchase or acquire a separate class of bank or BHC stock at a lower price than other subscribers or with greater voting rights.
- Purchase stock at an original issue price lower than that paid by other investors.
- Receive a cash payment based on the market value of the bank's stock.
- Remove cash from the bank's capital accounts.
- Obtain more than one option or warrant for each share of stock subscribed for Type 1 and Type 2 plans at the time of the bank's opening (see "Primary Types of Insider Stock Benefit Plans" discussion).
- Receive stock options or warrants issued to a holder other than the name of the bank insider, such as, a partnership, corporate entity, spouse, or other family member.
- Exercise "cashless" stock options, such as stock appreciation rights or phantom shares.

¹An established company is one that has been operating for more than three years and will become a BHC or a non-BHC parent of a national bank when the bank opens for business.

These compensation arrangements raise concerns about the bank's ability to raise additional capital, allow control without a proportionate financial investment, and make it difficult for other shareholders to remove directors if they manage the bank in an unsafe or unsound manner.

Excessive Compensation

Each national bank should maintain safeguards to prevent the payment of compensation that is excessive or that could lead to material financial loss to the bank. Excessive compensation is an unsafe and unsound practice and is prohibited by regulatory safety and soundness standards. The commitment to pay, or payment of, unacceptable or excessive compensation also reflects negatively on the organizing group's charter proposal. Compensation is considered excessive when amounts paid are unreasonable or disproportionate to the services performed by any person for a national bank.

If excessive compensation is discovered before the bank opens, the OCC will disallow payment of that compensation from bank funds. The OCC may request additional information from the organizing group to support the compensation or may require the organizers to change or eliminate the form or amount of compensation before it will authorize the bank to open for business. If the OCC finds that compensation is excessive, the OCC may preclude the bank from opening.

After the bank opens, if the OCC determines that compensation is excessive, the board is responsible for taking corrective action and seeking restitution. Appendix A to 12 CFR 30 — Interagency Guidelines Establishing Standards for Safety and Soundness addresses excessive compensation and lists the factors the OCC considers in its evaluation of compensation packages.

Accounting Considerations and Shareholder Disclosures

Organizers and boards are responsible to assure that each component of a bank's compensation package is accounted for properly and that regulatory reports are accurate. In addition, they should refer to the Internal Revenue Code and/or Securities and Exchange Commission rules for guidance about shareholder approval and disclosure. In general, organizers must disclose and describe fully insider compensation, including stock benefit plans, to all prospective stock subscribers in its registration statement or private placement document, regardless of whether shareholder approval is required for the plans.

Stock Benefit Plans

Bank organizers should structure any proposed stock benefit plan to encourage the participants' continued involvement in the bank. The plan also should serve as an incentive for the successful, long-term operation of the bank.

Stock benefit plans should contain **no** feature that would:

- Encourage speculative or high-risk activities.
- Serve as an obstacle or otherwise impede the sale of additional stock to the general public.
- Be structured to convey control of a national bank or otherwise provide preferential treatment to the bank's insiders.

Primary Types of Insider Stock Benefit Plans

In general, there are two primary types of stock benefit plans:

- Type 1 plans grant options/warrants to directors and active senior executive officers to reward future performance.
- Type 2 plans grant options/warrants to organizers as compensation for:
 - ◆ Financial risk borne to fund the formation and/or organization of a bank ("seed money");
 - ◆ Non-cash contribution of assets (such as, land for a banking facility) (see the "Capital and Dividends" booklet of the Manual);
 - ◆ The guarantee of a loan to finance a bank's organization; or
 - ◆ Professional services (such as, legal, accounting, or underwriting services) rendered to facilitate the establishment of the bank.

Type 1 Plans

Banks typically use Type 1 plans to reward senior executive officers and directors for future performance. Accordingly, their continuing involvement to support successful operations of the bank after it opens is **required** for participation in Type 1 plans. The plan need not grant stock options to all senior executive officers or directors of the new bank, but the organizing group should provide support for the number of options made available to each plan participant.

In some new banks, CEOs and other key officers may receive stock options at opening similar to "signing bonuses," which are intended to compensate them for financial risks they assume

in joining a new bank's management team. Financial risks to senior executive officers can be twofold. First, they often leave positions in established institutions that they may have held for extended periods. Second, these officers may find themselves subsequently unemployed for an extended period of time or need to take a lesser position in another institution if the new positions do not work out and they leave after a relatively short tenure. The OCC requires the terms of these stock option plans to conform to OCC policy guidelines. In addition, the OCC considers this form of compensation in its evaluation of overall compensation.

Type 2 Plans

Organizers may participate in Type 2 plans. Type 2 plans provide vehicles for organizing groups to reimburse organizers for financial risk borne during the organization phase, such as providing seed money, contributing organization funds or non-cash assets, or guaranteeing a loan. An organizer could elect to receive as compensation either cash or stock or any combination of the two.

The number of shares received is determined by dividing the amount to be reimbursed by the value of each share. Organizers may not receive stock options for additional stock subscribed that would exceed the amount for which they are being reimbursed. If stock options or warrants are received in exchange for an organizer's guarantee of a loan, each person's options or warrants should not exceed his or her pro rata amount of the loan guarantee or the amount drawn, if less than the guaranteed amount of the loan.

Professional services normally are paid for in cash. Professional service providers, however, may participate in Type 2 plans if the service provider lowers the cash payment for the service rendered to the organization as a result of plan participation.

If an organizer, who is also a service provider, is fully reimbursed in cash for all professional services, he or she can participate in a Type 2 plan only if stock compensation is elected for reimbursement of seed money, organization funds, contributions of non-cash assets, or loan guarantee.

Type 1 and Type 2 Plan Requirements

Type 1 and 2 stock benefit plans must include:

- A limited duration of rights (maximum of 10 years).
- An exercise, or strike, price of stock rights, which shall be no less than the fair market value of the stock at the time that the rights are granted.
- A clause that allows the OCC to direct the national bank to require plan participants to "exercise or forfeit" their stock rights if:
 - ◆ Capital falls below regulatory minimums as set forth in 12 CFR 3, or a higher requirement as the OCC may determine; or

- ◆ The existence of outstanding warrants impairs the bank's ability to raise capital.

Additional Type 1 Requirements

Type 1 stock benefit plans also must include the following requirements:

- A maximum of one option or warrant for each share subscribed (in other words, a "one for one" stock option or warrant plan).
- Vesting requirements that encourage the participant to remain involved in the bank's operations (for example, vesting approximately equal percentages each year over the initial three years of operations).
- Restrictions on the transferability of the options/warrants, except transfer to a holder's estate in the event of death or permanent disability.
- Rights upon termination of relationship with the bank.

Acceleration and Vesting of Unearned Options or Warrants

The OCC permits acceleration and vesting of earned and unearned options or warrants if:

- The stock benefit plan required a three-year minimum vesting period, and
- The three-year period has elapsed.

If one of the following circumstances exist, the OCC permits immediate acceleration and vesting without regard to the previous criteria:

- A senior executive officer, including the CEO, ceases to work for the bank after a change in ownership occurs.
- A director loses his or her position on the board after a change in ownership occurs.
- A senior executive officer or director becomes permanently disabled or dies.

The OCC requires a senior executive officer or director to forfeit unvested options/warrants under all other circumstances.

Rights of Termination

A senior executive officer or director who ceases to be an active participant in the bank's operations must exercise or forfeit options/warrants within 90 days after separation from or termination by the bank. In the event of permanent disability or death, the stock option holder or the person's estate should exercise options/warrants within 12 months or else forfeit the options.

Additional Type 2 Requirements

Unlike Type 1 plans, Type 2 stock benefit plans do not require vesting, transferability restrictions, or continued association with the national bank. Type 2 stock compensation plans, however, must meet the following additional plan requirements:

- A maximum of one option or warrant per share subscribed for the contribution of organization funds, non-cash assets, or guaranty of a loan for the new bank.
- A maximum of one option or warrant per share subscribed for the payment of professional services.

Management and Employee Stock Benefit Plans

In addition to Type 1 and Type 2 plans, the bank's board of directors may authorize a prospective management stock benefit plan (also called a stock incentive plan) for its senior executive officers and/or an employee stock option plan for its employees. In this context, the definition of senior executive officer is not confined to that included in Regulation O. Any insider who participates in a management stock incentive plan also would be considered a senior executive officer. Directors may participate in the plan as a method of payment for their services to the bank. In many cases, participation may be tied to specific individual or bank performance criteria.

Management and employee stock benefit plans should encourage the continued involvement of the participants and serve as an incentive for the successful, long-term operation of the bank. In addition, such plans should:

- Be viewed as part of an individual's total compensation.
- Be reasonable relative to the service provided.
- Include compliance with appropriate other laws, including applicable state and tax laws.

The bank should conform the terms of these plans to the requirements of Type 1 plans. Like other stock benefit plans, management and employee stock benefit plans should not encourage speculative or high-risk activities or serve as an obstacle to, or otherwise impede, the sale of additional stock to the general public.

Questions

Organizers should direct questions about this revised OCC policy to LIC staff in the appropriate district office.